paladin

ANNUAL REPORT 2003

Here today. Here for life.

FOCUSED on growth

FINANCIAL HIGHLIGHTS

For the years ended December 31

(In thousands of Canadian dollars except share and per share amounts)	2003	2002	2001	2000	1999	1998	1997	1996
Revenues	**23,859**	23,355	17,795	12,607	11,201	6,023	830	41
Income (loss) before write-downs and taxes	**2,511**	6,591	4,330	2,991	2,856	2,437	(4)	(594)
Net income (loss)	**(4,172)**	5,162	1,485	2,797	2,016	836	(1,006)	(1,868)
Earnings (loss) per share (basic)	**(0.28)**	0.37	0.12	0.24	0.22	0.13	(0.25)	(0.50)
Cash flows from operating activities	**5,444**	8,634	5,154	1,507	2,896	1,343	(446)	(285)
Cash and marketable securities	**44,547**	45,612	22,448	24,339	9,886	8,545	563	759
Shareholders' equity	**59,332**	63,178	37,836	35,769	13,830	9,886	2,390	3,146
Shares issued and outstanding	**14,799,588**	14,780,205	12,539,247	12,394,038	9,466,338	9,057,731	3,990,659	3,823,991

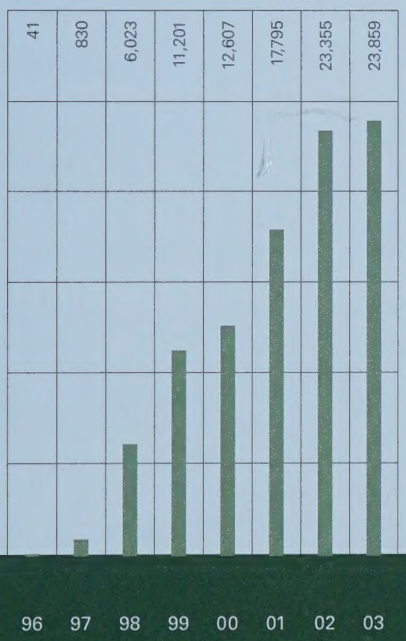
Paladin Labs Inc. is a specialty pharmaceutical company focused on marketing innovative urology, endocrinology and women's health products for the Canadian market.

Growth will be sustained through the acquisition of Canadian rights to promotion-sensitive pharmaceuticals and to promising products in late-stage clinical development.

Headquartered in Montreal, Paladin is a publicly traded company listed on the Toronto Stock Exchange (TSX) under the symbol PLB.

REVENUES

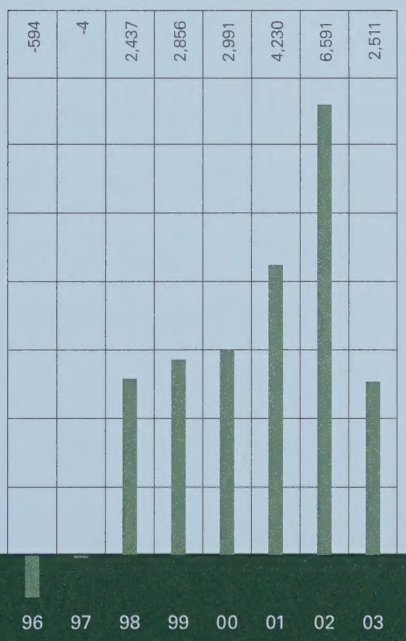
(In thousands of Canadian dollars)



- Eighth consecutive year of record revenues for Paladin.
- 148% compound annual revenue growth since 1996.
- Increased generic competition for our major product impeded 2003 revenue growth.
- 39% increase in 2003 revenues of key promoted products, including **Androderm®**, **Dalacin®**, **Dostinex®**, **Estring®** and **Plan B®**.

INCOME BEFORE WRITE-DOWNS AND TAXES

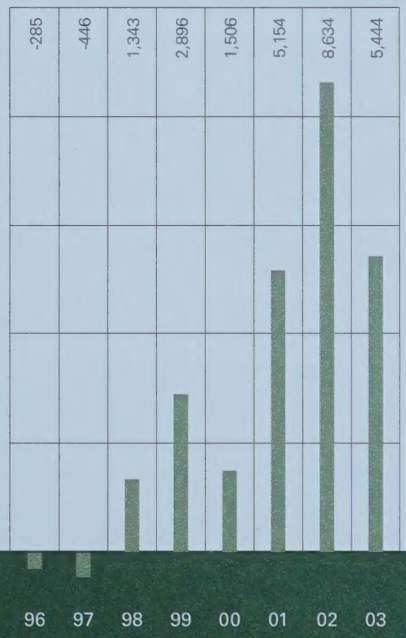
(In thousands of Canadian dollars)



- Increased sales and marketing expenditures for key promoted products resulted in a decrease in income before write-downs and taxes in 2003.
- $0.17 per share of income before write-downs and taxes in 2003.

CASH FLOWS FROM OPERATING ACTIVITIES

(In thousands of Canadian dollars)



- Sixth consecutive year of cash generated from operations.
- $0.37 per share of cash flows from operating activities in 2003.

A STRONG foundation, A PROMISING future

Dear Shareholders,

Paladin Labs confronted significant challenges in 2003 and emerged as a stronger company. We strengthened our foundation for future growth with the acquisitions of five innovative marketed products and two late-stage development products. As we faced increased generic competition on certain products, I am proud to say the Paladin team has responded decisively to minimize the impact and strengthen the Company for the future.

2003 ACCOMPLISHMENTS

MAY
- Paladin licenses **Diacol®**, a treatment to cleanse the bowel prior to a colonoscopy, from InKine Pharmaceuticals.

JUNE
- Health Canada recommends that **Plan B®**, an emergency contraceptive pill, be switched to non-prescription status.

AUGUST
- Paladin receives orphan drug designation for **Fidelin™** (DHEA) in the U.S. and Europe.

JONATHAN ROSS GOODMAN, B.A., LL.B., M.B.A.
PRESIDENT & CEO

Financial Performance

In 2003, Paladin recorded $23.9 million in revenue, our eighth consecutive year of record revenue, representing a slight increase from $23.4 million in fiscal 2002. Our 2003 growth was muted by increased generic competition for Urispas®, one of our leading brands in terms of historical sales; suspended sales of Valtaxin™ due to supplier manufacturing difficulties; and lower sales of Oesclim® due to recent medical concerns related to female hormone replacement therapies. The decline in sales of these products was offset by solid growth in our key promoted brands including, Androderm®, Dostinex®, Dalacin®, Estring® and Plan B® which increased by 39% in 2003.

Paladin's net loss for 2003 was $4.1 million, down from net income of $5.2 million in 2002. During 2003, we recorded charges against earnings totaling $9.1 million, mostly due to the write-down of the carrying value of distribution rights for a number of products in our portfolio that face a heightened risk of generic competition.

Growth through Strategic Acquisitions

In the second half of 2003, Paladin's business development team made progress in expanding our product portfolio, thereby strengthening our foundation for future growth. In the last twelve months, we successfully concluded licensing and distribution agreements for five innovative marketed products and two late-stage development products.

SEPTEMBER
- Paladin appoints Mark Nawacki as Vice President of Business Development.

OCTOBER
- Paladin's co-founders, Jonathan Ross Goodman and Mark Beaudet, named Quebec's Entrepreneurs of the Year in the Healthcare / Life Sciences Field in the Ernst & Young 2003 Entrepreneur of the Year Awards Program.

NOVEMBER
- Paladin signs a distribution agreement for a portfolio of products consisting of **Sandomigran®**, **Sintrom®**, and **Zaditen®** with PanGeo Pharma.
- Paladin signs a distribution agreement for **Cortifoam®**, a local anti-inflammatory therapy for ulcerative colitis and inflammatory bowel disease, with Meda AB.

DECEMBER
- Paladin acquires the Canadian rights for **Darvon-N®**, an analgesic indicated for the relief of pain, from Eli Lilly and Company.

JANUARY 2004
- Subsequent to year end, Paladin enters into a licensing agreement with Watson Pharmaceuticals for **Oxytrol®** , a novel transdermal patch for the treatment of over-active bladder.

In November, we entered into a distribution agreement with PanGeo Pharma (Canada) Inc. for a portfolio of prescription drug products consisting of Sandomigran®, Sintrom®, and Zaditen®. According to IMS Canada, these products had combined Canadian sales of $2 million in 2002. In addition, we acquired the rights to Cortifoam®, a local anti-inflammatory therapy for the adjunctive treatment of ulcerative colitis and inflammatory bowel disease, from Meda AB. Canadian sales of Cortifoam® amounted to $1.5 million in 2003 as valued by IMS Canada. In December, we acquired the distribution and marketing rights to Darvon-N® from Eli Lilly and Company. Darvon-N® is an analgesic that is indicated for the relief of mild to moderate pain. According to IMS Canada, Canadian sales of Darvon-N® in 2002 totaled $1.4 million.

Most significantly, we expanded our product pipeline with two late-stage development products. In May, we signed a Canadian licensing agreement with InKine Pharmaceutical Company, Inc. for Diacol® (Visicol® in the U.S.). Visicol® is the first patented sodium phosphate purgative in tablet format available in the U.S. and is used to cleanse the bowel prior to a colonoscopy, a commonly used screening technique for colon cancer. According to IMS Canada, the total Canadian market for purgative agents was $5.8 million in 2003. In early 2004, we signed a Canadian licensing agreement with Watson Pharmaceuticals, Inc. to market Oxytrol®, a novel transdermal patch for the treatment of overactive bladder. IMS Canada estimates the total Canadian market for overactive bladder in 2003 exceeded $42 million.

Advancing our Product Portfolio

In 2003, Health Canada recommended the switch from prescription to non-prescription status for Plan B®, our emergency contraceptive pill. The Canadian Ministry of Health is in the process of adapting the regulations to allow Plan B® to be sold without a prescription.

In terms of our pipeline products, we are pleased to report that we received orphan drug designation for Fidelin™ (DHEA) in both the U.S. and Europe. Orphan drug designation provides Fidelin™ with seven years of market exclusivity in the U.S. and ten years of market exclusivity in Europe, following regulatory approval. We are developing Fidelin™ for adrenal insufficiency, a rare chronic condition brought about by failure of the adrenal glands.

We continue to pursue Canadian regulatory approval for Circadin®, a novel treatment for sleep disorders in the elderly, and Statex® SR, a twice-daily morphine product used in the palliation of various categories of pain. In 2004, we plan to file New Drug Submissions (NDS) with Health Canada for Histrelin Hydrogel Implant, a once-yearly implant for the treatment of advanced prostate cancer, and GlucaGen®, a treatment for hypoglycemia in insulin-dependent diabetics.

Building the Foundation for Growth

Our primary areas of therapeutic focus will remain centered around urology, endocrinology and women's health. We will continue to benefit from our ability to leverage our strong network of specialist physician relationships to drive sales growth with new, innovative products. We also remain opportunistic, should an attractive opportunity arise to acquire products outside of our key areas of therapeutic focus, we will certainly take action.

With more than $44 million in cash and marketable securities as of December 31, 2003, we are well positioned to continue executing our strategy of acquiring promotion-sensitive brands from large pharmaceutical companies and, in support of our longer-term growth, products in late stage clinical development.

We remain committed to further strengthening our leadership position in the Canadian specialty pharmaceutical market and have the financial strength, expertise and determination to succeed. On behalf of the Board of Directors and everyone at Paladin, I would like to thank you for your continued support.

Sincerely,

JONATHAN ROSS GOODMAN, B.A., LL.B., M.B.A.

PRESIDENT & CEO

THE STAYING POWER


A healthy portfolio of products
A clear focus on shareholder value
OF PALADIN

ANDRODERM

ANDRODERM®, THE ONLY TRANSDERMAL TESTOSTERONE PATCH AVAILABLE IN CANADA, IS INDICATED FOR THE TREATMENT OF TESTOSTERONE DEFICIENCY IN MEN. LOW TESTOSTERONE LEVELS MAY CAUSE SYMPTOMS SUCH AS LOW ENERGY, POOR LIBIDO, ERECTILE DYSFUNCTION AND DEPRESSION. ANDRODERM® HELPS TO RESTORE TESTOSTERONE TO NATURAL LEVELS.

In 2003, the Canadian testosterone replacement therapy market was valued at $30 million and, over the last three years, has grown at a compound annual growth rate of 35 percent. This market includes testosterone injections, transdermal gel, oral treatments and Androderm®, the only transdermal patch.

With the recent launch of Androderm® in a 5 mg format, Paladin offers patients and physicians an easy, once-a-day, one-patch treatment option for testosterone deficiency.

Source: Morley, J.E. et al. Metab Clin Exp 1997; 46-4104.
IMS Health, Canadian Drug Store and Hospital Purchases Audit, 2003.
Androderm Product Monograph.

PRODUCT	INDICATION	LICENSOR/VENDOR
Androderm	Testosterone Defiency	Watson Pharmaceuticals
Muse	Erectile Dysfunction	Vivus
Pacis	Bladder Cancer	Shire Pharmaceuticals
pms-yohimbine	Alpha-Adrenergic Blocking Agent	Pharmascience
Rogitine	Alpha Adrenoreceptor Antagonist	Novartis Pharmaceuticals
Urispas	Urinary Incontinence	Altana Pharma
Valtaxin	Bladder Cancer	Anthra Pharmaceuticals
Oxytrol	Urinary Incontinence	Watson Pharmaceuticals
Aptosyn	Prostate Cancer	OSI Pharma
Histrelin Hydrogel Implant	Prostate Cancer	Valera Pharmaceuticals

OXYTROL

OXYTROL® IS THE FIRST AND ONLY TRANSDERMAL THERAPY IN THE U.S. INDICATED FOR THE TREATMENT OF OVER-ACTIVE BLADDER THAT IS CHARACTERIZED BY SYMPTOMS OF URINARY INCONTINENCE, URGENCY AND FREQUENCY.

According to the Canadian Continence Foundation, approximately 1.5 million Canadians suffer from overactive bladder and, according to IMS Canada, the total Canadian market for overactive bladder in 2003 exceeded $42 million.

Oxytrol® was accepted for regulatory review by the Therapeutic Products Directorate of Health Canada in May 2003, and was launched in the U.S. by Watson Pharmaceuticals in April 2003.

HISTRELIN HYDROGEL IMPLANT

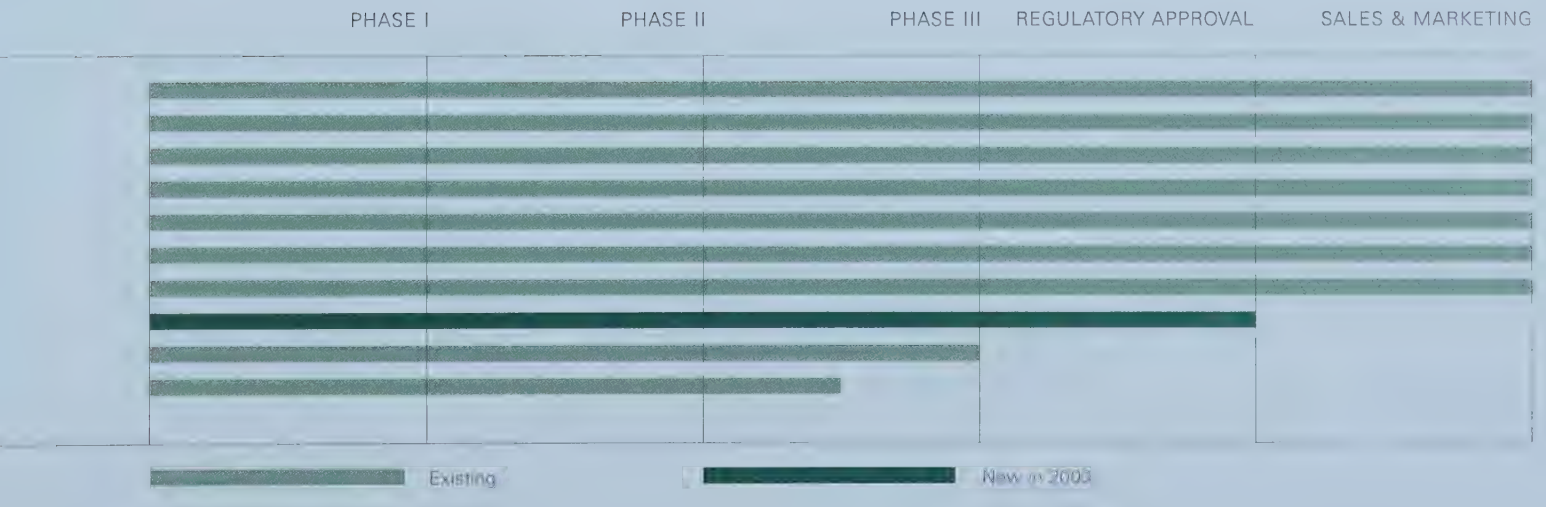
HISTRELIN HYDROGEL IMPLANT IS A UNIQUE, ONCE-YEARLY IMPLANT INDICATED FOR THE TREATMENT OF ADVANCED PROSTATE CANCER.

As it provides twelve months of continuous, steady-state drug delivery with a single treatment, it represents a compelling alternative to leuprolide, goserelin and buserelin injections, which are currently administered once every one, two, three or four months.

The National Cancer Institute of Canada estimates that, excluding skin cancers, prostate cancer is the most common cancer among Canadian men. Every year in Canada some 16,000 new cases are diagnosed and of those diagnosed as many as 4,000 die. According to IMS Canada, Histrelin Hydrogel Implant will compete in a market estimated at $120 million.

In the U.S., Valera Pharmaceuticals filed a New Drug Application in the fourth quarter of 2003.

* Source: National Cancer Institute of Canada: Canadian Cancer Statistics 1999.



DOSTINEX

DOSTINEX® IS INDICATED FOR THE TREATMENT OF HYPERPROLACTINEMIA, A CHRONIC CONDITION CHARACTERIZED BY AN EXCESS SECRETION OF THE HORMONE PROLACTIN.

Symptoms in women include infertility, absence of menstrual periods, and the discharge of breast milk. In men, hyperprolactinemia can cause lowered testosterone levels resulting in decreased libido, impotence and infertility.

Dostinex® competes in a market currently valued at $10 million with approximately 10,000 patients being treated every year in Canada for hyperprolactinemia. Dostinex® has superior efficacy and patient compliance when compared against the older therapy, bromocriptine.

Paladin has increased Dostinex® sales at a compound annual growth rate of 45 percent since its acquisition from Pharmacia in 2002. A key focus for the brand in 2003 was a series of nationwide continuing medical education lectures for specialists and primary care physicians on new Canadian guidelines for the diagnosis and management of hyperprolactinemia, authored by four leading Canadian endocrinologists.

Source: The prevalence of hyperprolactinemia in an unselected normal population is 0.4% (Biller, 1998).
Based on population data taken from Statistics Canada 2002, the patient population is estimated to be 126,000.

Biller BMK, Daniels GH: Neuroendocrine regulation and diseases of the anterior pituitary and hypothalamus. In Harrison's Principles of Internal Medicine. Fourteenth edition. Edited by AS Fauci, E Braunwald, KJ Isselbacher, et al. New York, McGraw Hill, 1998, pp 1972-1999.

Novel Canadian Guidelines for the Diagnosis and Management of Hyperprolactinemia, CMAJ 2003: 169(6) 575-581.

PRODUCT	INDICATION	LICENSOR/VENDOR
Dostinex	Hyperprolactinemia	Pfizer
Propyl-Thyracil	Hyperthyroidism	Merck Frosst
Tapazole	Hyperthyroidism	Eli Lilly
Circadin	Insomnia	Neurim Pharmaceuticals
GlucaGen	Hypoglycemia	Novo Nordisk
Fidelin (DHEA)	Addison's Disease	Neuroscience Pharma

GLUCAGEN® (RECOMBINANT GLUCAGON FOR INJECTION) IS CHEMICALLY IDENTICAL TO HUMAN GLUCAGON.

GLUCAGEN

Glucagon is indicated for the emergency treatment of hypoglycemia in diabetics being treated with insulin. It is also indicated for relaxation of the gastrointestinal tract during routine radiology procedures. GlucaGen® rapidly restores blood glucose levels in unconscious hypoglycemic patients, enabling them to regain consciousness and ingest other sources of glucose.

According to the Canadian Diabetes Association, between 35 and 65 percent of Type I diabetics experience severe hypoglycemia each year, a condition that may result in prolonged loss of consciousness or even death. IMS Canada reports that, as of September 2003, the annual market for glucagon totaled $3.9 million.

Source: 2001 Canadian Diabetes Association Clinical Practice Guidelines for the Prevention and Management of Hypoglycemia in Diabetes.

Paladin is presently working with Novo Nordisk Canada, to file a NDS for GlucaGen® with the Biologics and Gene Therapies Directorate of Health Canada within the coming year.

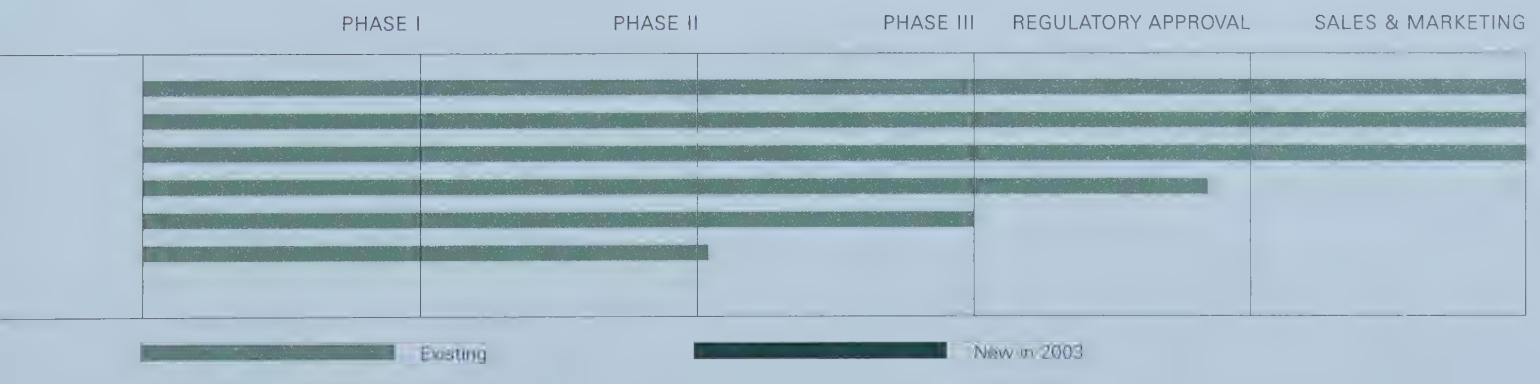
FIDELIN (DHEA)

DHEA IS A PREVALENT ENDOGENOUS ADRENAL HORMONE AND NEURO-STEROID THAT DECREASES WITH AGING.

A recent paper in the New England Journal of Medicine reveals that in a Phase II trial, women with Addison's Disease (adrenal insufficiency) had a statistically significant improvement in well-being and sexual function after taking 50 mg of DHEA daily. Adrenal insufficiency affects an estimated 100,000 patients in the U.S. and 115,000 patients in Europe. Health Canada, as well as the European authorities, classify DHEA as a new chemical entity that requires a full NDS and regulatory approval before it can be sold commercially in Canada.

Paladin continues to develop this product with the aim of gaining Canadian regulatory approval, and making Fidelin™ (DHEA) available to Canadian patients. Paladin is also pursuing marketing opportunities for Fidelin™ in the U.S. and Europe.

In 2003, Paladin received orphan drug designation for Fidelin™ in the U.S. and Europe. Orphan drug designation provides Fidelin™ with seven years of market exclusivity in the U.S. and ten years of market exclusivity in Europe, following regulatory approval.



ESTRING

ESTRING® IS A LOCAL ESTROGEN THERAPY INDICATED FOR THE TREATMENT OF POSTMENOPAUSAL UROGENITAL DISCOMFORT DUE TO ESTROGEN DEFICIENCY.

Estring® provides continuous, long-lasting relief for the vaginal dryness, soreness, itching, urinary urgency and painful or difficult urination commonly associated with urogenital atrophy (UGA).

According to IMS Canada, the Canadian hormone replacement therapy (HRT) market is currently valued annually at approximately $120 million and is dominated by systemic forms of HRT. Although recent studies on the long-term use of HRT have resulted in more cautious use of female HRT, local estrogen therapies are gaining favour as a safe and effective treatment for UGA. In fact, local estrogen prescriptions have grown by more than five percent over the last year.

The expected publication in 2004 of The Society of Obstetricians and Gynaecologists of Canada (SOGC) guidelines for the treatment of UGA will reinforce the benefit of local estrogen therapy use.

Source: Laurie A. Willhite et al. Urogenital Atrophy: Prevention and treatment. Pharmacotherapy, 21(4):464-480, 2001.
Ayton RA et al. A comparative study of safety and efficacy of continuous low dose oestradiol released from a vaginal ring compared with a conjugated equine oestrogen vaginal cream in the treatment of postmenopausal urogenital atrophy. Br J Obstet Gynecol 1996; 103:351-358.
Estring Product Monograph.

PRODUCT	INDICATION	LICENSOR/VENDOR
Dalacin Vaginal Cream	Bacterial Vaginosis	Pfizer
Estring	Urogenital-Menopause Symptoms	Pfizer
Oesclim	Menopause Symptoms	Laboratoires Fournier
Plan B	Emergency Contraceptive	Women's Capital Corporation
Prepidil	Cervical Ripening	Pfizer
Prostin	Labour Induction	Pfizer
Estradiol Gel	Menopause Symptoms	BioSante Pharmaceuticals
Estradiol + Testosterone Gel	Menopause Symptoms	BioSante Pharmaceuticals

PLAN B

PLAN B® IS THE ONLY EMERGENCY CONTRACEPTIVE (EC) PILL APPROVED IN CANADA. PLAN B® IS INDICATED FOR USE IN PREVENTING PREGNANCY AFTER KNOWN OR SUSPECTED CONTRACEPTIVE FAILURE OR UNPROTECTED SEX.

Source: Task Force on Postovulatory Methods of Fertility Regulation. Randomized controlled trial of levonorgestrel versus the Yuzpe regimen of combined oral contraceptives for emergency contraception. Lancet 1998; 352:428-433. Warner MS, Couchenoor RL. Pharmacotherapy 2002, 22(1):43-53.
SOGC Clinical Practice Guidelines, published in the JOGC Np. 131, August 2003.

The simple dosing regimen comes pre-packaged with two tablets in a convenient, two-step regimen. The first pill must be taken within seventy-two hours of intercourse, the second, twelve hours later. Recent SOGC guidelines recommend that both tablets can be taken simultaneously versus the older twelve-hours-apart regimen without any difference in efficacy or side effects.

An estimated 50 percent of the 470,000 pregnancies in Canada annually are unintended. Current oral EC prescriptions represent less than 10 percent of the potential market.

In 2003, Health Canada recommended that Plan B® be switched to non-prescription status. The Canadian Ministry of Health is approaching the Canadian Gazette process in order to adapt required regulations to allow Plan B® to be sold without a prescription.

DALACIN

DALACIN® VAGINAL CREAM IS INDICATED FOR THE TREATMENT OF BACTERIAL VAGINOSIS, A CONDITION THAT OCCURS WHEN BACTERIA NORMALLY PRESENT IN THE VAGINA BECOME OVERABUNDANT.

Dalacin® eliminates these pathogenic bacteria and restores normal levels of flora within the vagina.

According to IMS Canada, the Canadian Bacterial Vaginosis Local Therapy market is valued at $1 million and is expected to grow by approximately two percent.

In 2003, Paladin worked with Pfizer, Dalacin's manufacturer, to overcome production issues. The brand was re-launched in the last half of the year and will be promoted to women's health care professionals in 2004.

CORTIFOAM

Cortifoam® is a local anti-inflammatory therapy for the adjunctive treatment of inflammatory bowel disease. Cortifoam®'s unique foam delivery of hydrocortisone is well regarded by Canadian gastroenterologists and provides Paladin with a perfect match for Diacol®.

According to IMS Canada, Canadian sales of Cortifoam® were approximately $1.5 million in 2003.

DERMATOLOGY AND OTHER PRODUCTS

PRODUCT	INDICATION	LICENSOR/VENDOR
Allergens	Allergy Testing	Hermal GmbH
Canthacur	Plantar Warts	Pharmascience
Histofreezer	Common Warts	OraSure Technologies
Locacorten-Vioform	Topical Antimicrobial Corticosteroids	Novartis Pharmaceuticals
Podofilm	Genital Warts	Pharmascience
Wartec	Genital Warts	Stiefel Laboratories
Antizol	Ethylene Glycol or Methanol Poisoning	Orphan Medical
Cedocard	Anti-Anginal	Altana Pharma
Cerumol	Ear Wax Removal	Laboratories for Applied Biology
Cortifoam	Ulcerative Colitis	Meda AB
Nitrol	Anti-Anginal	Aventis S.A.
Ridaura	Rheumatoid Arthritis	Prometheus Laboratories
Sandomigran	Vascular Headaches / Migraines	PanGeo Pharma
Sintrom	Venous Thromboses (blood clots)	PanGeo Pharma
Vioform Hydrocortisone	Topical Antimicrobial Corticosteroids	Novartis Pharmaceuticals
Statex	Narcotic Analgesic	Pharmascience
Zaditen	Mild Atopic Asthmatic Children	PanGeo Pharma
Darvon-N	Relief of Mild to Moderate Pain	Eli Lilly
Statex SR	Narcotic Analgesic	Amarin Corporation
Diacol	Colon Cancer	InKine Pharmaceutical

GENERIC PRODUCTS

pms – lithium carbonate	Anti-Manic Agent	Pharmascience
pms – tryptophan	Affective Disorders	Pharmascience
pms – valproic acid	Anti-Convulsant	Pharmascience
pms – selegilene	Parkinson's Disease	Pharmascience
pms – flavoxate	Urinary Incontinence	Pharmascience

DIACOL

Diacol® is a sodium phosphate purgative in tablet format and is used to cleanse the bowel prior to a colonoscopy; a commonly used screening technique for colon cancer.

According to IMS Canada, the total Canadian market for purgative agents was $5.8 million in 2003, an increase of 14 percent over 2002. Approximately 300,000 colonoscopies are performed each year in Canada. These procedures are carried out by a select group of specialists, which enables Paladin to focus its future promotional efforts.

The following analysis explains the variations in the results of operations, financial position and cash flows for Paladin Labs Inc. ("Paladin" or the "Company") and is current as at March 5, 2004. This discussion should be read in conjunction with the information contained in the Company's financial statements and the related notes to the financial statements.

Forward-Looking Statements

This document contains forward-looking statements, which reflect the Company's current expectations regarding future events. The forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance and demand for new pharmaceutical products, the impact of competitive products and pricing, new product development and launch, availability of raw materials, the regulatory environment, fluctuations in operating results and other risks. Many risks are inherent in the pharmaceutical industry; others are more specific to Paladin. Investors should consult the Company's ongoing quarterly filings, annual reports and Annual Information Form for additional information on risks and uncertainties relating to these forward-looking statements.

Overview

Paladin is a specialty pharmaceutical company focused on selling and marketing innovative pharmaceutical products for the Canadian market. Through a national sales force, the Company markets its pharmaceutical products to Canadian physicians in its key therapeutic areas.

Paladin's strategy is to acquire promotion-sensitive products with existing sales and to increase sales of these products through focused marketing and promotion. The Company also in-licenses late-stage development products, obtains regulatory approval for them and then launches them in the Canadian market.

In 2003, Paladin made solid progress in acquiring the rights to innovative products and expanding sales of key promoted products:

- Paladin acquired the Canadian distribution rights to i) **Cortifoam®**, a local anti-inflammatory therapy for the adjunctive treatment of ulcerative colitis and inflammatory bowel disease from Meda AB; ii) **Darvon-N®**, an analgesic indicated for the relief of pain from Eli Lilly and Company; iii) a portfolio of products consisting of **Sandomigran®**, **Sintrom®** and **Zaditen®** from PanGeo Pharma; and, iv) **Diacol®**, a patented sodium phosphate purgative used to cleanse the bowel prior to a colonoscopy, from InKine Pharmaceutical.

- Subsequent to the fiscal year end, Paladin signed a licensing agreement with Watson Pharmaceuticals for the Canadian distribution rights for **Oxytrol®**, a novel transdermal patch for the treatment of overactive bladder.

- Paladin received orphan drug designation for **Fidelin™** (DHEA) in the U.S. and Europe.

- Health Canada recommended that **Plan B®**, an emergency contraceptive, be switched to non-prescription status.

- Paladin achieved solid growth of its key promoted products, including **Androderm®**, **Dostinex®**, **Dalacin®**, **Estring®** and **Plan B®**, which increased by 39% in 2003.

Paladin's revenues reached $23,859 for the year ended December 31, 2003 compared to $23,355 for the year ended December 31, 2002. For the year ended December 31, 2003, the Company's net loss was $4,172 or $0.28 per share compared to net income of $5,162 or $0.36 diluted per share for the year ended December 31, 2002.

As at December 31, 2003, the Company's total assets were $68,970, and shareholders' equity was $59,332. The Company's cash and short-term marketable securities amounted to $44,547 as at December 31, 2003.

As at December 31, 2002, the Company's total assets were $68,655, and shareholders' equity was $63,178. The Company's cash, cash equivalents, and short-term and long-term marketable securities amounted to $45,612 as at December 31, 2002.

Paladin's revenue is principally derived from sales of pharmaceutical products to large pharmaceutical wholesalers and large chain pharmacies.

Paladin utilizes a "pull-through" marketing approach that is typical of pharmaceutical companies. Paladin's sales representatives demonstrate the features and benefits of its products to physicians who may write prescriptions for Paladin's products. These physicians write prescriptions for their patients, who, in turn, take the prescriptions to pharmacies to be filled. The pharmacies then place orders with the wholesalers, or, in case of large chain pharmacies, their distribution centers, to whom Paladin sells its products.

The Company's expenses have been comprised primarily of selling, marketing and administrative expenses, cost of goods sold (including royalty payments to those companies from whom Paladin licenses its products) and research and development expenses. In addition, because Paladin acquires many of the products that it markets, a substantial portion of the Company's expenses are related to amortization of intangible assets and deferred charges.

Paladin's annual and quarterly operating results are primarily affected by the following factors: the level of acceptance of Paladin's products by physicians and their patients; and wholesaler buying patterns. Wholesaler buying patterns, including a tendency to increase inventory levels prior to anticipated or announced price increases, affect the Company's operating results by shifting revenue between quarters. To ensure that Paladin maintains good relations with wholesalers, Paladin typically gives wholesalers prior

notice of price increases to enable them to purchase products that they will later sell at higher prices. The level of patient and physician acceptance of Paladin's products, as well as the availability of similar therapies, impact Paladin's revenues by driving the level and timing of prescriptions for its products.

Critical Accounting Estimates

Paladin's financial statements are prepared in accordance with Canadian generally accepted accounting principles, applied on a consistent basis. Paladin's critical accounting estimates include revenue recognition, the recording of research and development expenses, the useful lives and fair value of intangible assets and stock based compensation expense.

Revenue Recognition

Revenue is recognized when the product is shipped to the Company's customers, provided the Company has not retained any significant risks of ownership or future obligations with respect to the product shipped. Revenue from product sales is recognized net of sales discounts and allowances, which are based on estimates. In certain circumstances, returns or exchange of products are allowed under the Company's policy, and estimated provisions are made for such returns and exchanges.

Intangible Assets

Intellectual property acquired is recorded at cost and consists primarily of process know-how covered by certain patented and non-patented information. Pharmaceutical product licenses, rights and intellectual property are amortized on a straight-line basis over the lesser of the term of the agreement, the life of the patent or the expected useful life of the product. The terms generally range from 4 to 10 years, but may extend to 20 years. Management reviews the carrying value based on projected future results annually and whenever events or changes in circumstances indicate that the asset may be impaired. Any impairment in the carrying value results in a write-down of the pharmaceutical product license and right and intellectual property which is charged to income during the year.

During the fourth quarter of 2003, the Company reduced the estimated useful life of intellectual property associated with products with no patent protection or protection under a license agreement. This intellectual property relates to products which may be genericized and whose estimated useful life has been reduced to 5 years from the date of acquisition.

Research and Development Expenses

Research costs are charged to income in the year of expenditure and include milestone payments for products currently under development. Development costs are charged against income in the year of expenditure unless a development project meets the criteria under generally accepted accounting principles for deferral and amortization. The Company has not deferred any such development costs to date. Research and development expenses are recorded net of government assistance, including investment tax credits, which are based on estimates of amounts expected to be recovered and are subject to audit by taxation authorities.

Stock-Based Compensation Plans

The Company has stock-based compensation plans. No stock-based compensation expense was reflected in the net income of 2002. During the fourth quarter of 2003, the Company adopted the fair value method of accounting for stock-based compensation plans for fiscal 2003. A charge for stock-based compensation has been recorded as an expense and reflected in net income of fiscal 2003. The calculation of stock-based compensation is dependent on estimates to determine the fair value. The fair value of the option is calculated using Black-Scholes option-pricing model, which requires making assumptions of the volatility factor of the market price of the Company's common shares and the expected life of the option. The Company has selected the prospective method of adoption; accordingly, results from prior years have not been restated.

Selected Financial Information

INCOME STATEMENT DATA

For the years ended December 31

(In thousands of Canadian dollars except per share amounts)	**2003** $	**%**	2002 $	%	2001 $	%
Revenues	**23,859**	**100**	23,355	100	17,795	100
Gross profit	**17,695**	**74**	16,968	73	12,007	67
Earnings before write-downs and income taxes	**2,511**	**11**	6,591	28	4,330	24
Write-down of intellectual property and investments, net	**8,479**	**36**	427	2	2,402	13
Earnings before income taxes	**(5,968)**	**(25)**	6,164	26	1,928	11
Net income (loss)	**(4,172)**	**(11)**	5,162	22	1,485	8
Income (loss) per common share						
Basic	**(0.28)**		0.37		0.12	
Diluted	**(0.28)**		0.36		0.12	

BALANCE SHEET DATA

As at December 31

(In thousands of Canadian dollars)	**2003** $	2002 $	2001 $
Cash and short-term and long-term marketable securities	**44,547**	45,612	22,448
Current assets	**49,561**	42,745	27,327
Total assets	**68,970**	68,655	45,191
Long-term financial liabilities	**-**	-	544
Shareholders' equity	**59,332**	63,178	37,836

No dividend was declared or paid by Paladin on its Common Shares during the current financial year. In addition, the Company does not expect to pay dividends in the next financial year.

Results of Operations

Year ended December 31, 2003 compared to year ended December 31, 2002

Revenues

Revenues increased $504 or 2% to $23,859 for the year ended December 31, 2003 from $23,355 for the year ended December 31, 2002. This increase was due to strong market performance from the Company's key promoted products, including Androderm®, Dostinex®, Dalacin®, Estring® and Plan B®, which increased by 39% compared to the year ended December 31, 2002. The increase in revenues was partially offset by a decline in sales of Urispas®, as a result of generic competition; suspended sales of Valtaxin™, due to supplier manufacturing difficulties; and, a decline in sales of Oesclim®, due to the recent medical concerns relating to female hormone replacement therapies.

Gross Profit

Total gross profit increased $727 or 4% to $17,695 for the year ended December 31, 2003 from $16,968 for the year ended December 31, 2002. Gross profit, as a percentage of revenues, improved to 74% for the year ended December 31, 2003 from 73% for the year ended December 31, 2002. This increase in gross profit, as a percentage of sales, resulted primarily from a higher proportion of products sold for which the Company earns a distribution fee and consequently does not incur costs of sales related to these products.

Selling and Marketing Expense

Selling and marketing expense increased $4,225 or 61% to $11,142 for the year ended December 31, 2003 from $6,917 for the year ended December 31, 2002. Selling and marketing expense, as percentage of revenues, increased to 47% for the year ended December 31, 2003 from 30% for the year ended December 31, 2002. This increase was primarily attributed to increased spending on sales and marketing activities behind the Company's key promoted products. These expenses include charges for 26 full time contract sales representatives for several months during fiscal 2003. It is expected that selling and marketing expense, as a percentage of revenues, will be between 30% and 35% for the year ended December 31, 2004.

General and Administrative Expense

General and administrative expense increased $201 or 8% to $2,627 for the year ended December 31, 2003 from $2,426 for the year ended December 31, 2002. This increase was primarily attributed to the Company's adoption of the fair value method of accounting for stock-based compensation plans, which resulted in a charge of $227 in 2003. General and administrative expense, as a percentage of revenues, increased to 11% for the year ended December 31, 2003 from 10% for the year ended December 31, 2002.

Research and Development Expense

Research and development expense increased $218 or 20% to $1,302 for the year ended December 31, 2003 from $1,084 for the year ended December 31, 2002. This increase was primarily due to higher staffing costs and associated costs required to support Fidelin™ (DHEA) and other products in various stages of development including further Canadian regulatory expense for currently marketed products.

Amortization Expense

Amortization expense increased $236 or 14% to $1,946 for the year ended December 31, 2003 from $1,710 for the year ended December 31, 2002. This increase reflected the impact of amortization expense related to the Company's acquisition of licenses, rights and intellectual property during the year ended December 31, 2003.

During the fourth quarter of 2003, the Company reduced the estimated useful life of intellectual property associated with products with no patent protection or protection under a license agreement. This intellectual property relates to products which may be genericized and whose estimated useful life has been reduced to five years from the date of acquisition. Consequently, this change will result in accelerated amortization of intangible assets related to products with no patent protection in future periods. As such, amortization expense is expected to increase by approximately 200% in fiscal 2004.

Interest Income

Interest income increased $347 or 33% to $1,412 for the year ended December 31, 2003 from $1,065 for the year ended December 31, 2002. This increase reflects the impact of increased cash available for investment during the year ended December 31, 2003 compared to the year ended December 31, 2002.

Other Income

Other income decreased $274 or 39% to $421 for the year ended December 31, 2003 from $695 for the year ended December 31, 2002. For the year ended December 31, 2003, other income includes a one-time compensation payment for

lost revenues of Dalacin® and other payments related to certain license and trademark license agreements. For the year ended December 31, 2002, the Company received $695 related to certain license and trademark license agreements.

Write-Down of Intellectual Property
During 2003, the Company recorded write-downs and gains associated with the intellectual property described below.

a) Management determined certain products were at a higher risk of generic competition than had been previously estimated. The Company prepared undiscounted cash flows related to these product sales and assessed that in some cases, the carrying value of the related intellectual property was in excess of its net recoverable amount. The Company then prepared discounted cash flows for these products and has written the carrying value down to the discounted value, resulting in a write-down of $5,115.

b) Management determined that certain products under development had a sufficiently high risk of not being approved for sale, and consequently, that there was a limited expectation of future cash flows. The Company has recorded an impairment charge of $199.

c) The Company entered into a license agreement for Oesclim®, a hormone replacement therapy (HRT) patch for women. Given the decline in sales of Oesclim® due to recent concerns relating to female HRT, the Company concluded that there was an impairment in the carrying value and recorded an impairment loss of $1,725, representing the full carrying value of this license.

d) The distribution agreement with Bioniche Life Sciences Inc. for Cystistat® was terminated for net proceeds of $80. The net proceeds were recorded as a gain.

Effective January 1, 2003, the Company sold the MoiStir® trademark and assigned the licenses of Sialor® and the Baker Cummins line of dermatology products to a related party, a subsidiary of JODDES, and recorded a gain of $278.

During 2002, the Company recorded write-downs and gains associated with the intellectual property described below.

a) Management reviewed the projected future cash flows for Rogitine® and determined that there was an impairment in the carrying value of this license. Consequently, the Company recorded a write-down of $474.

b) The Company returned the rights to DepoCyt™ to SkyePharma, Inc. for net proceeds of $639. The Company recorded a gain of $47 representing the difference between the value of the consideration received and the net carrying value of the intellectual property related to DepoCyt™ of $750 less the accumulated amortization of $158.

Write-Down of Investments
During 2003, the Company recorded write-downs and gains associated with the investments described below.

a) In June 2003, Anthra Pharmaceuticals, Inc. ("Anthra") advised the Company that it had disposed of virtually all of its assets and was unable to determine when it would be able to resume production of its marketed product, Valtaxin™. The Company considers that there has been a permanent impairment in the carrying value of the investment in Anthra. Anthra is a private corporation based in the U.S. and it is not practicable within constraints of timeliness and cost to determine the fair value of the common shares. Consequently, the Company recorded a write-down of $1,497, representing the full amount of its carrying value of its investment in Anthra.

b) In December 2003, management determined that the decline in the market value of BioSante Pharmaceuticals, Inc. was other than temporary. Consequently, the Company recorded a write-down of $526 related to this investment.

c) The Company disposed all of its common shares of Connetics Corporation. The Company recorded a gain of $225 representing the difference between the proceeds received of $529 and its carrying value of $304.

Income Tax Expense
Income tax expense decreased $2,798 to a recovery of $1,796 for the year ended December 31, 2003 from $1,002 for the year ended December 31, 2002. The effective tax rate was 30% for the year ended December 31, 2003 compared to 16% for the year ended December 31, 2002.

Net Income (Loss)
Due to the factors set forth above, net loss was $4,172 for the year ended December 31, 2003 compared to net income of $5,162 for the year ended December 31, 2002.

Liquidity and Capital Resources

The Company believes that its existing cash and cash equivalents and short-term marketable securities, as well as cash generated from operations are sufficient to finance its current operations and working capital needs and future product acquisitions. At present, the Company is actively pursuing product acquisitions that may require the use of substantial capital resources. There are no present agreements or commitments with respect to any such acquisitions.

Paladin's cash, cash equivalents, and short-term and long-term investments decreased $1,065 to $44,547 at December 31, 2003 from $45,612 at December 31, 2002. Working capital increased $2,655 to $39,923 at December 31, 2003 from $37,268 at December 31, 2002. This increase is primarily due to an increase in short-term marketable securities offset by an increase in balance of license agreements payable.

Effective February 1, 2004, the Company has amended its distribution agreement with its affiliate (see Related Party Transactions). As a result of this amendment, Paladin will take ownership of inventory and accounts receivables related to products distributed by Paladin. The related party will continue to provide logistics services, including customer service, warehousing and shipping, and collection services. Consequently, Paladin's total assets will increase by approximately $4 million related to accounts receivables. In addition, the Company purchased approximately $3 million of inventory from this affiliate.

Cash flows from operating activities were $5,444 and $8,634 for the years ended December 31, 2003 and 2002, respectively. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, write-down of intellectual property, future income taxes and imputed interest.

The Company's investing activities used cash of $9,531 and $27,041 for the years ended December 31, 2003 and 2002, respectively. During the year ended December 31, 2003, the Company invested $9,969 in acquisitions of pharmaceutical product licenses and rights and intellectual property. The Company received $949 from the disposal of investments and pharmaceutical product licenses. In addition, the Company had a $1,036 net decrease in short-term and long-term marketable securities. The principle uses of cash in fiscal 2002 were acquisitions of pharmaceutical product licenses and rights and intellectual property of $4,496. In addition, the Company had a $23,122 net increase in short-term and long-term marketable securities.

Cash flows from financing activities were $4,058 and $18,449 for the years ended December 31, 2003 and 2002, respectively. For the year ended December 31, 2003, cash was provided from common stock option exercises and the issuance of common shares under the stock purchase plan. In addition, the Company had an increase of $4,602 in accounts payable related to pharmaceutical product licenses, of which $1,444 was paid in January 2004, and paid $650 related to the balance of sales payable. For the year ended December 31, 2002, cash was provided for the issuance of special warrants less related issuance of costs. In addition, cash was provided from common stock option exercises and the issuance of common shares under the stock purchase plan. Further, the Company had a decrease of $1,731 in accounts payable related to pharmaceutical product licenses.

Related Party Transactions

JODDES Limited ("JODDES"), a private Canadian corporation, is a significant shareholder holding approximately 45% of the outstanding shares of the Company, and one director of the Company, the Company's President and CEO, is related to JODDES. In June 1998, the Company entered into a number of ten-year agreements each with five-year renewal options with a wholly owned subsidiary of JODDES. Under these agreements, this affiliate provides manufacturing and logistics services including, customer service, warehousing and shipping, invoicing and collection services on behalf of the Company. Effective February 1, 2004, Paladin amended the distribution agreement with this affiliate. As a result of this amendment, Paladin has begun to invoice customers and collect accounts receivables and has taken title to the inventory and accounts receivables related to the products distributed by Paladin. Consequently, Paladin's total assets will increase by approximately $4 million related to accounts receivables. In addition, the Company purchased approximately $3 million of inventory from this affiliate. The Company also engages this affiliate to perform certain research and development services. These service contracts are on a pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of JODDES. This lease is for a period of 2 years and includes minimum payments of $133. All transactions with affiliated companies are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount.

The table below reflects all transactions and services with affiliates, including those referred to in the agreements described above:

(In thousands of Canadian dollars)	**2003 $**	2002 $
Sales	**1,075**	1,669
Purchases	**5,516**	5,259
Research and development expenses	**241**	483
Sales and marketing expenses	**1,319**	1,196
General and administrative expenses	**265**	266

Effective January 1, 2003, the Company sold the MoiStir® trademark and assigned the licenses of Sialor® and the Baker Cummins line of dermatology products to a related party, a subsidiary of JODDES, and recorded a gain of $278.

On November 5, 2003, the Company purchased a three-year license and distribution agreement from PanGeo Pharmaceutical (Canada) Inc. ("PanGeo"). On November 6, 2003, PanGeo was purchased by JODDES, and at December 31, 2003, $170 of the purchase price remained outstanding.

Fourth Quarter Analysis

During the fourth quarter, management determined certain products were at a higher risk of generic competition than had been previously estimated. The Company prepared undiscounted cash flows related to these product sales and assessed that, in some cases, the carrying value of the related intellectual property was in excess of its net recoverable amount. The Company then prepared discounted cash flows for these products and has written the carrying value down to the discounted value, resulting in a write-down of $5,115. In addition, management determined that certain products under development had a sufficiently high risk of not being approved for sale, and consequently, that there was a limited expectation of future cash flows. The Company has recorded an impairment charge of $199. Further, given the decline in sales of Oesclim® due to recent concerns relating to female HRT, the Company concluded that there was an impairment in the carrying value and recorded an impairment loss of $1,725, representing the full carrying value of this license.

In December 2003, management determined that the decline in the market value of BioSante Pharmaceuticals, Inc., a publicly traded U.S. company, was other than temporary. Consequently, the Company recorded a write-down of $526 related to this investment.

Subsequent Events

Subsequent to the year end, in January 2004, the Company entered into two marketing and distribution agreements. Under these contracts, the Company paid initial licensing fees of US$350. In addition, specific payments will be required under these agreements if certain milestones are met such as regulatory approval in Canada or specific sales volumes. Based on the outcome of these milestones, the Company may have to pay up to $2,333 (US$1,800).

Changes in Accounting Policies

Effective January 1, 2003, the Company prospectively adopted the new CICA Section 3063 accounting recommendation on the impairment of long-lived assets. When the carrying value of a long-lived asset is less than its net recoverable value as determined on an undiscounted cash flow basis, an impairment loss is recognized. The impairment loss is recognized to the extent that its fair value measured on a discounted cash flow basis, over the life of the asset, is below the asset's carrying value. Prior to January 1, 2003, asset impairments were recorded to the extent that the amount of an asset's carrying value exceeded its net recoverable amount on an undiscounted cash flow basis.

The adoption of CICA Section 3063 has increased the write-down of intellectual property in the current year by approximately $1,500.

During the year, the CICA amended their pronouncement relating to stock-based compensation, requiring companies to measure and expense all equity instruments awarded to employees. In the fourth quarter of 2003, the Company adopted this new recommendation prospectively. Consequently, the Company has applied fair value based method to expense employee options awarded since January 1, 2003. Furthermore, for options awarded or modified during fiscal 2002, the Company will continue to present the pro forma net income information as if the fair value basis had been applied to those awards.

Risk Factors

For a more detailed discussion of the risk factors that could materially affect the results of operations and the financial condition of the Company, please refer to the Company's Annual Information Form.

Contractual Obligations and Commitments

In the normal course of business, Paladin secures Canadian development, sales, marketing and distribution rights to innovative drug products and has entered into various agreements which include contractual obligations extending beyond the current year. The Company has the following contractual obligations related to product license, trademark and distribution agreements:

CONTRACTUAL OBLIGATIONS

(In thousands of Canadian dollars)	Total	Less than 1 year	After 1-3 years	4-5 years	5 years
Purchase and service based commitments	$16,491	4,250	6,788	3,232	2,221

In addition, under certain agreements, Paladin may have to pay additional consideration should the Company achieve certain sales volumes or if certain milestones are met, such as regulatory approval in Canada. The Company has the following commitments related to product license, trademark and distribution agreements:

COMMITMENTS

(In thousands of Canadian dollars)	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Milestone based commitments	$3,928	-	1,340	-	2,588
Revenue based commitments	$5,259	-	402	737	4,120

QUARTERLY INFORMATION

	2003				2002			
(In thousands of Canadian dollars except per share amounts)	Q1 $	Q2 $	Q3 $	Q4 $	Q1 $	Q2 $	Q3 $	Q4 $
Sales	**5,065**	**6,453**	**5,420**	**6,921**	5,344	5,687	6,087	6,237
Income before write-downs and income taxes	**715**	**1,631**	**463**	**288**	1,636	1,688	1,808	1,459
Net income (loss)	**573**	**(83)**	**381**	**(4,960)**	1,401	1,440	1,533	788
Fully diluted EPS	**0.04**	**(0.01)**	**0.03**	**(0.34)**	0.11	0.10	0.10	0.05

MANAGEMENT'S REPORT

The accompanying financial statements of Paladin Labs Inc. and all of the information in this Annual Report are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The most significant of these accounting principles are described in *note 2* to the financial statements. The financial statements include amounts that are based on estimates and judgements. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly in all material respects. The Company's accounting procedures and related systems of internal control are designed to provide reasonable assurance that its assets are safeguarded and its financial records are reliable. The financial information elsewhere in this annual report is consistent with the information presented in the financial statements.

The Board of Directors has appointed an Audit Committee consisting of three outside directors. The committee meets periodically during the year to review with management and the external auditors any significant accounting, internal control and auditing matters. They review and finalize the annual financial statements of the Company along with the external auditors' report prior to the submission of the financial statements to the Board of Directors for final approval.

The Company's external auditors, Ernst & Young LLP, Chartered Accountants, conduct an independent audit on behalf of the shareholders, in accordance with Canadian generally accepted auditing standards, and express their opinion on the financial statements. Their report outlines the scope of their audit and their opinion on the financial statements of the Company. The external auditors have full access to management and the Audit Committee of the Board.

Montreal, Canada,
January 26, 2004

JONATHAN ROSS GOODMAN,
B.A., LL.B., M.B.A.
PRESIDENT & CEO

SAMIRA SAKHIA ,
B.COMM, C.A., M.B.A.
CHIEF FINANCIAL OFFICER

AUDITORS' REPORT

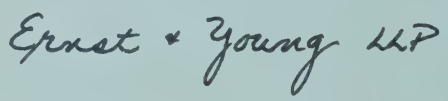
To the Shareholders
of Paladin Labs Inc.

We have audited the balance sheets of Paladin Labs Inc. as at December 31, 2003 and 2002 and the statements of operations and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Montreal, Canada,
January 26, 2004



ERNST & YOUNG LLP
CHARTERED ACCOUNTANTS

As at December 31

(In thousands of Canadian dollars)	2003 $	2002 $
Assets		
Current		
Cash and cash equivalents	**1,991**	2,020
Short-term marketable securities *(note 4)*	**42,556**	36,572
Accounts receivable and other assets *(note 5)*	**2,789**	2,607
Investment tax credits receivable *(note 14)*	**256**	325
Future income tax assets *(note 15)*	**1,969**	1,221
Total current assets	**49,561**	42,745
Long-term marketable securities *(note 6)*	**—**	7,020
Property, plant and equipment *(note 7)*	**132**	72
Intangible assets *(note 8)*	**12,359**	12,703
Deferred charges *(note 9)*	**2,781**	1,515
Investments *(note 10)*	**1,877**	2,771
Future investment tax credits recoverable *(note 15)*	**659**	470
Future income tax assets *(note 15)*	**1,601**	1,359
	68,970	68,655
Liabilities and shareholders' equity		
Current		
Accounts payable and accrued liabilities	**4,546**	3,103
Accounts payable to related parties *(note 13)*	**170**	—
Income taxes payable	**85**	109
Balance of license agreements payable *(note 13)*	**4,537**	555
Balance of sale payable	**—**	597
Deferred credit *(note 15)*	**300**	1,113
Total current liabilities	**9,638**	5,477
Shareholders' equity		
Capital stock *(note 11)*	**57,440**	57,334
Contributed surplus	**87**	87
Other paid-in capital *(note 11)*	**243**	23
Retained earnings	**1,562**	5,734
Total shareholders' equity	**59,332**	63,178
	68,970	68,655

See accompanying notes

On behalf of the Board:

JONATHAN ROSS GOODMAN
DIRECTOR

MARK BEAUDET
DIRECTOR

Years ended December 31

(In thousands of Canadian dollars except for share and per share amounts)	2003 $	2002 $
Revenues *(note 13)*	**23,859**	23,355
Cost of sales *(note 13)*	**6,164**	6,387
Gross profit	**17,695**	16,968
Selling and marketing *(note 13)*	**11,142**	6,917
General and administrative *(note 13)*	**2,627**	2,426
Research and development *(notes 13 and 14)*	**1,302**	1,084
Amortization of intangible assets and deferred charges	**1,946**	1,710
Write-down of intellectual property, net *(note 12)*	**6,681**	427
Write-down of investments, net *(note 10)*	**1,798**	—
Interest income, net	**(1,412)**	(1,065)
Other income	**(421)**	(695)
Income (loss) before income taxes	**(5,968)**	6,164
Provision (recovery) for income taxes *(note 15)*		
Current	**88**	102
Future	**(1,884)**	900
	(1,796)	1,002
Net income (loss)	**(4,172)**	5,162
Retained earnings, beginning of year	**5,734**	572
Retained earnings, end of the year	**1,562**	5,734
Earnings (loss) per share		
Basic	**(0.28)**	0.37
Diluted	**(0.28)**	0.36
Weighted average number of shares outstanding *(note 16)*		
Basic	**14,787,733**	13,989,832
Diluted	**14,787,733**	14,160,630

See accompanying notes

Years ended December 31

(In thousands of Canadian dollars)	2003 $	2002 $
Operating activities		
Net income (loss) for the year	**(4,172)**	5,162
Add items not affecting cash		
Amortization	**2,000**	1,733
Write-down of intellectual property	**7,039**	474
Write-down of investments in other companies	**2,023**	—
Gain on disposal of investment	**(225)**	—
Future income taxes	**(1,991)**	195
Imputed interest on balance of sale	**53**	53
Non-cash compensation expense	**227**	—
Gain on disposal of intellectual property	**(358)**	(47)
	4,596	7,570
Net change in non-cash balances relating to operations	**848**	1,064
Cash flows from operating activities	**5,444**	8,634
Investing activities		
Additions to pharmaceutical product licenses and rights, intellectual property and deferred charges	**(9,969)**	(4,496)
Acquisition of property, plant and equipment	**(114)**	(62)
Purchases of short-term marketable securities	**(52,608)**	(46,350)
Maturities of short-term marketable securities	**61,580**	30,248
Purchases of long-term marketable securities	**(7,936)**	(7,020)
Proceeds from disposal of pharmaceutical license	**420**	639
Proceeds from disposal of investments	**529**	—
Net increase in investment	**(1,433)**	—
Cash flows used in investing activities	**(9,531)**	(27,041)
Financing activities		
Accounts payable related to the acquisition of intellectual property and deferred charges	**4,602**	(1,731)
Common shares issued for cash	**86**	219
Issuance of special warrants	**—**	20,952
Share issue costs, net of tax	**—**	(1,011)
Repayment of share purchase loan	**20**	20
Payment of balance of sale	**(650)**	—
Cash flows from financing activities	**4,058**	18,449
Net change in cash and cash equivalents during the year	**(29)**	42
Cash and cash equivalents, beginning of year	**2,020**	1,978
Cash and cash equivalents, end of year	**1,991**	2,020
Cash and cash equivalents consist of:		
Cash	**1,991**	1,162
Cash equivalents	**—**	858
Supplemental cash flow information		
Interest paid	**12**	2
Income taxes paid	**102**	114

See accompanying notes

1. NATURE OF OPERATIONS

Paladin Labs Inc. (the "Company") is a Canadian public company continued under the *Canada Business Corporations Act*. The Company's shares are traded on the Toronto Stock Exchange. The Company's business consists of in-licensing or acquiring, marketing, distributing and developing pharmaceutical products in Canada. Substantially all of the revenues are generated from the sale and distribution of pharmaceutical products in Canada and one customer, an affiliated company, accounts for 5% (2002 – 7%) of sales *(note 13)*.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles, the most significant of which are described below:

Use of estimates
The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates, and such differences could be material.

Cash and cash equivalents
Cash consists of bank deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value, and consist primarily of bankers' acceptances with maturities of three months or less.

Short-term and long-term marketable securities
Short-term marketable securities are recorded at the lower of cost and market value on a portfolio basis. Long-term marketable securities are recorded at their cost and are written down to their market value when a decline in market value is other than temporary.

Investments
Investments in common shares of private and public companies, where the Company does not exercise significant influence, are accounted for by the cost method whereby earnings are recognized only to the extent that dividends are declared. Annually, or whenever events or changes in circumstances indicate, the Company performs a review of its investments to determine if there has been other than temporary impairment in value. Any impairment in the value of the investment results in a write-down which is charged to income during the year.

Property, plant and equipment
Property, plant and equipment are recorded at cost. Amortization is provided on a basis and at rates assigned to amortize the cost of the assets over their estimated useful lives as follows:

Computer equipment and software	30% declining balance

Intangible assets
In the normal course of business, the Company secures Canadian development, sales, marketing and distribution rights to innovative drug products. Intellectual property acquired is recorded at cost and consists primarily of process know-how covered by certain patented and non-patented information. Pharmaceutical product licenses, rights and intellectual property are amortized on a straight-line basis over the lesser of the term of the agreement, the life of the patent or the expected useful life of the product. The terms generally range from 4 to 10 years, but may extend to 20 years. Management reviews the carrying value based on projected future results with the estimates made at the time the intangible asset was acquired, annually and whenever events or changes in circumstances indicate that the asset may be impaired. Any impairment in the carrying value results in a write-down of the intellectual property which is charged to income during the year.

During the fourth quarter of 2003, the Company reduced the estimated useful life of intellectual property associated with products with no patent protection or protection under a license agreement. This intellectual property relates to products which may be genericized and whose estimated useful life has been reduced to five years from the date of acquisition.

Deferred charges
Under a number of operating agreements, the Company has agreed to pay certain amounts over periods ranging from three to five years and has obtained the exclusive distribution rights to certain products. The deferred charges are amortized over the term of the distribution right. Management reviews the carrying value based on projected future results annually and whenever events or changes in circumstances indicate that the asset may be impaired. Any impairment in the carrying value of the deferred charge results in a write-down charged to income during the year.

Revenue recognition
Revenue is recognized when the product is shipped to the Company's customers, provided the Company has not retained any significant risks of ownership or future obligations with respect to the product shipped. Revenue from product sales is recognized net of sales discounts and allowances. In certain circumstances, returns or exchange of products are allowed under the Company's policy and provisions are maintained accordingly.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES (cont'd)

Government assistance
Amounts received or receivable resulting from government assistance programs, including grants and investment tax credits for research and development, are reflected as reductions to the cost of the assets or expenses to which they relate at the time the eligible expenditures are incurred, provided that there is reasonable assurance that the benefits will be realized.

Research and development
Research costs are charged to income in the year of expenditure and include milestone payments for products currently under development. Development costs are charged against income in the year of expenditure unless a development project meets the criteria under generally accepted accounting principles for deferral and amortization. The Company has not deferred any such costs to date.

Interest income
Interest income is recognized as it accrues to the Company.

Income taxes
The Company provides for income taxes using the liability method. Under this method, future income tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect in the period in which the future tax assets or liabilities are expected to be realized or settled. Future income tax assets are recognized to the extent that it is more likely than not that they will be realized.

Deferred credit
Deferred credit results from the acquisition of future income tax benefits arising from a business combination. The deferred credits are charged to income tax expense, as these benefits are realized.

Stock-based compensation plans
The Company has stock-based compensation plans, which are described in note 11. No stock-based compensation expense was reflected in the net income of 2002. Any consideration paid by employees on exercise of stock options or purchase of stock is credited to share capital. If stock or stock options are repurchased from employees, the excess of the consideration paid over the carrying amount of the stock or stock options cancelled is charged to retained earnings. In addition, options issued to consultants are recognized as an expense in the period they are granted using the Black-Scholes option-pricing model.

During the fourth quarter of 2003, the Company adopted the fair value method of accounting for stock-based compensation plans. The Company has selected the prospective method of adoption; accordingly, results from prior years have not been restated *(note 3)*.

Share issue costs
Share issue costs incurred by the Company are recorded as a reduction of capital stock.

Earnings per share
Basic earnings per share are calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share are calculated using the treasury stock method, giving effect to the exercise of all dilutive factors. The treasury stock method assumes that any proceeds that could be obtained upon the exercise of options would be used to purchase common shares at the average market price during the period.

Foreign currency translation
Transactions arising in foreign currencies are translated into Canadian dollars at the exchange rate prevailing at the transaction dates. At the balance sheet date, monetary assets and liabilities denominated in foreign currencies are translated at the year-end rates of exchange. Exchange gains and losses arising from the translation of foreign currency items are included in the determination of net income under general and administrative expenses.

3. CHANGE IN ACCOUNTING POLICIES

(i) Effective January 1, 2003, the Company prospectively adopted the new CICA Section 3063 accounting recommendation on the impairment of long-lived assets. When the carrying value of a long-lived asset is less than its net recoverable value as determined on an undiscounted cash flow basis, an impairment loss is recognized. The impairment loss is recognized to the extent that its fair value measured on a discounted cash flow basis, over the life of the asset, is below the asset's carrying value.

Prior to January 1, 2003, asset impairments were recorded to the extent that the amount of an asset's carrying value exceeded its net recoverable amount on an undiscounted cash flow basis.

The adoption of CICA Section 3063 has increased the write-down of intellectual property in the current year by approximately $1,500.

(ii) During the year, the CICA amended their pronouncement relating to stock-based compensation, requiring companies to measure and expense all equity instruments awarded to employees. In the fourth quarter of 2003, the Company adopted this new recommendation prospectively. Consequently, the Company has applied fair value based method to expense employee options awarded since January 1, 2003. Furthermore, for options awarded or modified during fiscal 2002, the Company will continue to present the pro forma net income information as if the fair value basis had been applied to those awards (*note 11*).

4. SHORT-TERM MARKETABLE SECURITIES

	2003 $	2002 $
Corporate bonds, earning interest at rates ranging from 2.41% to 3.77% (2.95% to 3.79% in 2002) and maturing on various dates from February 2004 to June 2004 (February 2003 to December 2003 in 2002)	**7,094**	14,170
Government bonds, earning interest at rates ranging from 2.50% to 4.39% (2.86% to 3.76% in 2002) and maturing on various dates from January 2004 to November 2004 (May 2003 to September 2003 in 2002)	**23,080**	13,951
Discount notes, earning interest at rates ranging from 3.40% to 3.60% (2.72% to 3.75% in 2002) and maturing on various dates from January 2004 to June 2004 (February 2003 to April 2003 in 2002)	**7,531**	8,451
Commercial paper, earning interest at rates ranging from 2.48% to 2.60% and maturing on various dates from January 2004 to April 2004 (February 2003 to April 2003 in 2002)	**4,851**	—
	42,556	36,572

Short-term marketable securities are comprised of seven investments (five in 2002) in corporate bonds, with one corporation representing eleven investments in bonds issued by or guaranteed by various Canadian and Provincial governments (five in 2002), two in discount notes (three in 2002) issued by unrelated public corporations, and two in commercial paper (none in 2002) issued by unrelated public corporations.

Two corporations account for $10,859 (2002 – nil) and two crown corporations, whose bonds are federally guaranteed, account for $17,569 (2002 – two crown corporations whose bonds are guaranteed by the Federal government – $11,651, and one corporation whose bond is guaranteed by a Provincial government – $4,985) of the short-term marketable securities.

5. ACCOUNTS RECEIVABLE AND OTHER ASSETS

	2003 $	2002 $
Receivable from an affiliated company *(note 13)*	**401**	1,697
Interest receivable	**332**	263
Other receivables	**1,968**	366
Other assets	**88**	260
	2,789	2,586

Other receivables consist primarily of commodity taxes receivable of $1,694 (2002 – $139) and trade receivables of $248 (2002 – $200).

6. LONG-TERM MARKETABLE SECURITIES

	2003 $	2002 $
Bonds guaranteed by the Federal government, earning interest at rates ranging from 3.83% to 4.39% and maturing on various dates from January 2004 to June 2004	—	7,020
	—	7,020

7. PROPERTY, PLANT AND EQUIPMENT

	2003 $	2002 $
Computer equipment and software	**223**	109
Less: accumulated amortization	**91**	37
Net carrying value	**132**	72

8. INTANGIBLE ASSETS

	2003 $	2002 $
Pharmaceutical product licenses and rights	**14,341**	14,050
Less: accumulated amortization	**1,982**	1,347
Net carrying value	**12,359**	12,703

During 2003, the Company paid $3,332 (2002 - $4,421) for intangible assets and recorded amortization expense of $1,137 (2002 - $900).

9. DEFERRED CHARGES

	2003 $	2002 $
Deferred charges	**4,400**	2,325
Less: accumulated amortization	**1,619**	810
Net carrying value	**2,781**	1,515

During 2003, the Company recorded an amortization expense of $809 (2002 - $810).

10. INVESTMENTS

	2003 $	2002 $
Investment in common shares of Connetics Corporation ("Connetics"), a public corporation in the United States (US$200) (2002 market value – $412) (see note (i) below)	**—**	304
Investment in common shares of Anthra Pharmaceuticals, Inc. ("Anthra"), (US$1,000) (market value – see note (ii) below)	**—**	1,497
Investment in common shares of BioSante Pharmaceuticals, Inc. ("BioSante"), a public company in the United States (US$636) (market value $449 see note (iii) below (2002 – $444)) (see note (iii) below)	**444**	970
Investment in Series B 10% Convertible Preferred Stock of Valera Pharmaceuticals, Inc. ("Valera") (see note (iv) below)	**1,433**	—
	1,877	2,771

Management's review to determine if there has been other than a temporary decline in the market value of these investments below the carrying value may require the Company to recognize an impairment charge on the remaining value of its investments which could be material.

(i) The Company disposed all of its common shares of Connetics during 2003. The Company recorded a gain of $225 representing the difference between the proceeds received of $529 and its carrying value of $304.

(ii) In June 2003, Anthra advised the Company that it had disposed of virtually all of its assets and was unable to determine when it would be able to resume production of its marketed product, Valtaxin™. The Company considers that there has been a permanent impairment in the carrying value of the investment in Anthra. Anthra is a private corporation based in the United States and it is not practicable within constraints of timeliness and cost to determine the fair value of the common shares. Consequently, the Company recorded a write-down of $1,497, representing the full amount of its carrying value of its investment in Anthra.

(iii) In December 2003, management determined that the decline in the market value of BioSante was other than temporary. Consequently, the Company recorded a write-down of $526 related to this investment.

(iv) On May 28, 2003, the Company purchased 1,333,333 Series B convertible preferred voting shares of Valera representing less than 10% of the outstanding share capital on an issued and on a fully diluted basis. Valera is a private corporation based in the United States and it is not practicable within the constraints of timeliness and cost to determine the fair value of the preferred shares.

11. CAPITAL STOCK

Authorized
100,000,000 common shares without nominal or par value.

Issued and outstanding

	2003		2002	
	Number of shares	**Amount $**	Number of shares	Amount $
Balance, beginning of year	**14,780,205**	**57,334**	12,539,247	37,154
Issued during the year:				
Conversion of special warrants	**—**	**—**	2,205,500	20,952
Exercise of stock options	**10,750**	**45**	30,041	183
Employee share purchase plan	**8,633**	**41**	5,417	36
Share issue costs, net of income taxes	**—**	**—**	—	(1,011)
Employee share purchase loan	**—**	**20**	—	20
Balance, end of year	**14,799,588**	**57,440**	14,780,205	57,334

At December 31, 2003, the amount of the share purchase loan to a former employee is $40 ($60 in 2002) collateralized by 6,000 common shares (9,000 in 2002), having a fair market value of $30 ($36 in 2002).

Shareholders Rights Plan
The Company has a Shareholders Rights Plan ("Rights Plan"). Under the Rights Plan, holders of voting shares are entitled to one share purchase right ("Right") for each voting share held, if any person or group makes a take-over bid or acquires 20% or more of the Corporation's outstanding voting shares without complying with the Rights Plan. Each Right entitles the registered holder, other than the acquiring person and parties related to the acquiror, to purchase five (5) common shares from treasury at its current market price.

Stock Option Plan
The Company has a Stock Option Plan ("Plan") in place for the benefit of key employees, directors, officers and consultants of the Company to purchase an aggregate maximum of 1,497,000 common shares (2002 – 900,000). As at December 31, 2003, 398,813 (2002 – 155,023) common share options remain available under the Plan. The number of common share options granted, the exercise price of any option granted and the vesting period shall be determined by the Board of Directors and is not to exceed 10% of the outstanding common shares. The exercise price will not be less than the closing price per common share on the date of grant.

On December 6, 2001, the Board amended the Plan to extend the term of the options to seven years and the vesting period to four years. On December 4, 2002, the Board amended options granted prior to December 6, 2001, increasing the option term from five to seven years.

The changes to the number of stock options granted by the Company and their weighted average exercise price are as follows:

	2003		2002	
	Number	**Weighted average exercise price $**	Number	Weighted average exercise price $
Balance, beginning of year	**706,524**	**6.18**	694,833	5.71
Granted	**354,818**	**4.63**	144,258	8.16
Exercised	**(10,750)**	**4.16**	(30,041)	6.10
Forfeited	**(176,608)**	**6.22**	(102,526)	5.81
Balance, end of year	**873,984**	**5.57**	706,524	6.18
Options exercisable at end of year	**412,001**	**5.74**	294,129	5.66

11. CAPITAL STOCK (cont'd)

Additional information concerning stock options outstanding as at December 31, 2003 is as follows:

Exercise price	Options outstanding			Options exercisable	
	Number	Weighted average months to expiry	Weighted average exercise price	Number	Weighted average exercise price
$3.16 - $4.25	**104,447**	**73**	**4.18**	**32,039**	**4.18**
$4.30 - $4.60	**274,539**	**54**	**4.44**	**133,727**	**4.30**
$5.00 - $5.90	**169,093**	**55**	**5.17**	**77,204**	**5.12**
$6.35 - $7.00	**276,763**	**57**	**6.69**	**135,752**	**6.85**
$9.60 - $10.00	**49,142**	**61**	**9.89**	**33,279**	**9.95**
	873,984			**412,001**	

During 2003, the Company adopted the fair value based method of accounting for employee stock compensation on a prospective basis. For options which were granted or modified during fiscal 2002, the Company will continue to present pro forma net income as if the fair value had been applied to those awards. The Company recorded an expense of $220 related to stock option awards granted during 2003, with a corresponding credit included in other paid-in capital. The fair value of option grants during 2003 was estimated at the date of grant using the following assumptions: weighted average risk-free interest rate of 4.45%; dividend yield of nil; weighted average volatility factor of the expected market price of the Company's common shares of 69%; and a weighted average expected life of the options of seven years. The estimated fair value of the options is amortized to expense on a straight-line basis over the option's vesting period. The weighted average fair value of stock options granted during 2003, under the Black-Scholes option-pricing model and above assumptions, was $3.21.

The fair value of option grants during 2002 was estimated at the date of grant using the following assumptions: weighted average risk-free interest rate of 5.02%; dividend yield of nil; weighted average volatility factor of the expected market price of the Company's common shares of 76%; and a weighted average expected life of the options of seven years. For purposes of pro forma disclosures, the estimated fair value of the options granted prior to 2003 will continue to be disclosed as an expense on a straight-line basis over the option's vesting period for pro forma purposes. The weighted average fair value of stock options granted during 2002, under the Black-Scholes option-pricing model and above assumptions, was $6.05.

For options for which the option term was amended from five years to seven years, the fair value was estimated at the date of amendment using the following assumptions: weighted average risk-free interest rate of 4.06%; dividend yield of nil; weighted average volatility factor of the expected market price of the Company's common shares of 72%; and a weighted average expected life of the options of 3.5 years. The weighted average fair value of stock options amended on December 4, 2002, under the Black-Scholes option-pricing model and above assumptions, was $4.06.

	2003 $	2002 $
Net income (loss) as reported	**(5,680)**	5,162
Less:		
Amortization of fair value related to options granted in fiscal 2002	**117**	323
Amortization of fair value related to the option life amendment in 2002	**109**	43
Pro forma net (loss) income	**(5,906)**	4,796
Basic earnings (loss) per share		
As reported	**(0.28)**	0.37
Pro forma	**(0.30)**	0.34
Diluted earnings (loss) per share		
As reported	**(0.28)**	0.36
Pro forma	**(0.30)**	0.34

Stock Purchase Plan

The Company has a Stock Purchase Plan ("Purchase Plan") allowing permanent employees to purchase up to 200,000 common shares at fair market value. During 2003, 8,580 (5,417 in 2002) shares were issued at fair market value under the Purchase Plan.

Under the Purchase Plan, the Company will contribute 25% of employees' contributions to a maximum of 6% of the employees' salary in the form of common shares. The Company will make its contribution if the employee remains employed by the Company and has held the original shares for two years from the original purchase date. During 2003, the Company issued 53 shares (none in 2002) representing its 25% contribution and recorded a corresponding expense of $7 (none in 2002).

12. GAIN AND WRITE-DOWN ON DISPOSITION OF INTELLECTUAL PROPERTY

	2003 $	2002 $
Products with risk of genericization (i)	**5,115**	474
Products under development (ii)	**199**	—
Oesclim® (iii)	**1,725**	—
Gain on disposal (iv)	**(358)**	(47)
	6,681	427

The Company recorded write-downs and a gain associated with intellectual property as described below.

(i) During 2003, management determined that certain products were at a higher risk of generic competition than had been previously estimated. The Company prepared undiscounted cash flows related to these product sales and assessed that, in some cases, the carrying value of the related intellectual property was in excess of its net recoverable amount. The Company then prepared discounted cash flows for these products and has written the carrying value down to the discounted value, resulting in a write-down of $5,115.

During 2002, management reviewed the projected future cash flows for Rogitine® and determined that there was an impairment in the carrying value of this license. Consequently, the Company recorded a write-down of $474.

(ii) During 2003, management determined that certain products under development had a sufficiently high risk of not being approved for sale, and consequently, that there was a limited expectation of future cash flows. The Company has recorded an impairment charge of $199.

(iii) The Company entered into a License Agreement for Oesclim®, a hormone replacement therapy (HRT) patch for women. Given the decline in sales of Oesclim® due to recent concerns relating to female HRT, the Company concluded that there was an impairment in the carrying value and recorded an impairment loss of $1,725, representing the full carrying value of this license.

(iv) During 2003, the distribution agreement with Bioniche Life Sciences Inc. for Cystistat® was terminated for net proceeds of $80. The net proceeds were recorded as a gain.

Effective January 1, 2003, the Company sold the MoiStir® trademark and assigned the licenses of Sialor® and the Baker Cummins line of dermatology products to a related party, a subsidiary of JODDES, and recorded a gain of $278.

During 2002, the Company returned the rights to DepoCyt™ to SkyePharma, Inc. for net proceeds of $639. The Company recorded a gain of $47, representing the difference between the value of the consideration received and the net carrying value of the intellectual property related to DepoCyt™ of $750 less the accumulated amortization of $158.

13. RELATED PARTY TRANSACTIONS

JODDES Limited ("JODDES"), a private Canadian corporation, is a significant shareholder, holding approximately 45% of the outstanding shares of the Company, and one director of the Company, the Company's President and CEO, is related to JODDES. In June 1998, the Company entered into a number of ten-year agreements each with five-year renewal options with a wholly owned subsidiary of JODDES. Under these agreements, this affiliate provides manufacturing and logistics services, including customer service, warehousing and shipping, and invoicing and collection services on behalf of the Company. The Company also engages this affiliate to perform certain research and development services. The Company also leases its office facilities from another wholly owned subsidiary of JODDES. All transactions with affiliated companies are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount.

Other than the related party transactions disclosed elsewhere in these financial statements, the table below reflects all transactions and services with affiliates, including those referred to in the agreements described above.

	2003 $	2002 $
Sales	**1,075**	1,669
Purchases	**5,516**	5,259
Research and development expenses	**241**	483
Sales and marketing expenses	**1,319**	1,196
General and administrative expenses	**265**	266

On November 5, 2003, the Company purchased a three-year license and distribution agreement from PanGeo Pharmaceutical (Canada) Inc. ("PanGeo"). On November 6, 2003, PanGeo was purchased by JODDES, and at December 31, 2003, $170 of the purchase price remained outstanding.

14. RESEARCH AND DEVELOPMENT AND GOVERNMENT ASSISTANCE

The Company incurred research and development expenditures, which are eligible for investment tax credits. The investment tax credits recorded are based on management's estimates of amounts expected to be recovered and are subject to audit by taxation authorities. The amounts can be summarized as follows:

	2003 $	2002 $
Research and development expenditures	**1,477**	1,451
Investment tax credits	**(175)**	(367)
	1,302	1,084

15. INCOME TAXES

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's future tax assets and liabilities are as follows:

	2003 $	2002 $
Future income tax assets		
Current		
Tax basis of intangible and other assets in excess of carrying value	**875**	303
Scientific Research and Experimental Development expenditures not claimed for tax purposes	**845**	700
Tax benefit of share issue costs	**211**	218
Charitable donations	**38**	—
	1,969	1,221
Long-term		
Tax basis of intangible assets in excess of carrying value	**1,520**	500
Scientific Research and Experimental Development expenditures not claimed for tax purposes	**759**	950
Tax benefit of share issue costs	**184**	409
	2,463	1,859
Total future income tax assets	**4,432**	3,080
Future income tax liabilities		
Long-term		
Tax basis of deferred charges less than carrying value	**862**	500
Total future income tax liabilities	**862**	500
Net future income tax assets	**3,570**	2,580

The Company's income tax provision (recovery) consists of the following:

	2003 $	2002 $
Provision at Canadian statutory rates (33.13%) (2002 – 35.16%)	**(1,977)**	2,167
Increase (decrease) resulting from:		
Net drawdown of deferred credit	**(513)**	(1,460)
Large corporation tax	**88**	102
Impact of change in tax rates	**170**	86
Tax effect of capital losses	**279**	—
Other	**157**	107
	(1,796)	1,002

15. INCOME TAXES (cont'd)

As at December 31, 2003, the Company had Scientific Research and Experimental Development expenditures available for Federal and Provincial income tax purposes, amounting to approximately $6,178 and $5,492, respectively, which may be applied against taxable income of future years. The Company also has Federal investment tax credits from Scientific Research and Experimental Development expenditures amounting to $659 which expire between 2010 and 2013. The benefit related to these items has been recognized in the financial statements.

The Company has capital losses carried forward totalling $495 which have not been recognized in the financial statements.

The Company recorded a gross reduction of current tax expense reflecting the claiming of Federal and Provincial losses carryforward and Scientific Research and Experimental Development expenditures in the current year in the amount of $813 (2002 - $1,460). The amount of the tax benefits claimed in the current and prior years, are subject to audit by the taxation authorities and could be reduced by a material amount in the future.

16. EARNINGS (LOSS) PER SHARE

The following summarizes the reconciliation of the basic weighted average number of shares outstanding and the diluted weighted average number of shares outstanding used in the diluted earnings per share calculations:

	2003	2002
	$	$
Basic weighted average number of shares outstanding	**14,787,733**	13,989,832
Dilutive effect of stock options	**—**	167,004
Dilutive effect of warrants	**—**	3,794
Diluted weighted average number of shares outstanding	**14,787,733**	14,160,630

There was no adjustment to net income for purposes of calculating diluted earnings per share. For 2003, the Company's diluted loss per share is equivalent to its basic loss per share, since all of the Company's potentially issuable options would have an anti-dilutive effect.

17. COMMITMENTS

In the normal course of business, the Company secures Canadian development, sales, marketing and distribution rights to innovative drug products and has entered into various agreements which include contractual obligations extending beyond the current year. These obligations are classified into three major categories: revenue based, milestone based and purchase based commitments.

Revenue based commitments
Most pharmaceutical product license agreements require that the Company make royalty payments ranging from 2.5% to 20% of sales, or require payments for products at rates ranging from 26% to 50% of the net selling price, or 60% of the net profit on sales.

In addition, the Company may have to pay up to $3,618 (US$2,800) if the Company achieves specific sales volumes on specific products in the future, over a maximum of 10 years.

Milestone based commitments
The Company has also committed to fund certain research and development expenditures of third parties for $323 (US$250) over the next two years. In addition, additional payments may be required under these agreements if milestones are met, such as regulatory approval in Canada. Based on the outcome of these milestones, the Company may have to pay up to $2,499, including US$1,868, over a maximum period of 15 years.

Purchase and service based commitments
The Company is committed to making minimum spending related to inventory purchases, regulatory, sales and marketing expenditures in the amount of $13,919, including US$250, in order to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual amounts are as follows:

	$
2004	3,928
2005	2,722
2006	2,566
2007	1,626
2008	856
2009 – 2011	2,221

18. FINANCIAL INSTRUMENTS

(i) **Fair values**

Short-term financial assets and liabilities

The carrying amounts of cash and cash equivalents, short-term marketable securities, accounts receivable and accounts payable are a reasonable estimate of their fair values because of the short maturity of these instruments.

The effective rate of return on cash equivalents and marketable securities is approximately 3.2% (2002 – 2.7%).

(ii) **Concentration of credit risk**

Investment tax credits receivable and research and development tax credits receivable are due from the Federal and Provincial governments. Cash and cash equivalents and short-term and long-term marketable securities consist of bonds or commercial paper in a number of publicly listed corporations and Provincial and Federal governments.

19. SUBSEQUENT EVENTS

Subsequent to the year end, in January 2004, the Company entered into two marketing and distribution agreements. Under these contracts, the Company paid initial licensing fees of US$350. In addition, specific payments will be required under these agreements if certain milestones are met such as regulatory approval in Canada or specific sales volumes. Based on the outcome of these milestones, the Company may have to pay up to $2,333 (US$1,800).

20. COMPARATIVE FIGURES

Certain of the comparative figures have been reclassified to conform to the presentation adopted in the current year.

TED WISE [2] – CHAIRMAN (SINCE 1995)
Mr. Wise is a co-founder, previous President and Vice-Chairman of Pharmascience Inc. Mr. Wise, a pharmacist by profession, has more than forty years of experience in the pharmaceutical industry, having worked for Ayerst Laboratories, Winley-Morris Ltd. and ICN Canada.

JONATHAN ROSS GOODMAN – DIRECTOR (SINCE 1995)
Prior to founding Paladin, Mr. Goodman was Vice President of Business Development at Pharmascience Inc. Mr. Goodman was formerly a consultant with Bain & Company, and also worked in brand management for Procter & Gamble.

MARK BEAUDET – DIRECTOR (SINCE 1996)
Prior to joining Paladin, Mr. Beaudet managed marketing and sales for Pharmascience's Innovative Business Unit. Mr. Beaudet was previously a Marketing Manager with Pizza Hut Canada. Prior to that, Mr. Beaudet was a Brand Manager in Procter & Gamble's Health Care division.

ROBERT LANDE [1] – DIRECTOR (SINCE 1995)
Mr. Lande is the former Chief Financial Officer of Telecom Américas Ltd. and former President of Bell Canada International do Brasil, the representative office of Bell Canada International in Brazil.

GER VAN AMERSFOORT [1] – DIRECTOR (SINCE 2001)
Mr. van Amersfoort was President & CEO of Novartis Canada Ltd., until his retirement in 2001. From 1987 to 1999 he was a regional President & CEO of SmithKline Beecham in the Netherlands, Canada, the United Kingdom and Ireland.

MICHAEL TARNOW [1] – DIRECTOR (SINCE 2001)
Mr. Tarnow is President & CEO of Huntington Venture, LLC, a firm involved in the development of early to mid-stage healthcare companies. He also is the Chairman of Xenon Genetics. From 1995 to 2000, Mr. Tarnow served as President & CEO of Creative BioMolecules, Inc. (CURIS, Inc.). Previously, Mr. Tarnow was President & CEO of Merck Frosst Canada Ltd.

ALDO BAUMGARTNER [2] – DIRECTOR (SINCE 2003)
Dr. Aldo R. Baumgartner was President & CEO of Wyeth-Ayerst Canada Inc. from 1992 until his retirement in February 2003. Prior to joining Wyeth-Ayerst, Dr. Baumgartner was President and General Manager of Hoffman-LaRoche's Belgian operations. He also served as President & CEO of Hoffmann-La Roche Canada from 1981 until 1988.

GERALD McDOLE [1] – DIRECTOR (SINCE MARCH 2004)
Mr. McDole was President & CEO of AstraZeneca Canada Inc., until his retirement in October 2003. He is the former Chairman of the Advanced Coronary Treatment Foundation and a former director of the Institute of Health Economics in Edmonton and the Canadian Stroke Network. He is past President of the Canadian Foundation for Pharmacy.

[1] member of the Audit Committee
[2] member of the Compensation Committee

MANAGEMENT TEAM

JONATHAN ROSS GOODMAN, B.A., LL.B., M.B.A.
PRESIDENT & CEO
(Please see Board of Directors)

MARK BEAUDET, B.COMM
VICE PRESIDENT OF MARKETING & SALES
(Please see Board of Directors)

SAMIRA SAKHIA, B.COMM, C.A., M.B.A.
CHIEF FINANCIAL OFFICER
Prior to joining Paladin, Ms. Sakhia held several leadership positions at Discreet Logic Inc., including Controller of North American Operations, Manager of International Financial Reporting (Montreal, Quebec), and European Financial Manager (London, England). Prior to Discreet Logic, Ms. Sakhia worked as an auditor at Arthur Andersen & Co.

TOM KOUTSAVLIS, BSC, MD CM, LMCC, MSC, CSPQ, FRCPC
VICE PRESIDENT OF SCIENTIFIC AFFAIRS
Before joining Paladin, Dr. Koutsavlis was Associate Medical Director and Program Director with CroMedica Inc., and Acting Senior Medical Director with PRA International in Ottawa, Canada. Dr. Koutsavlis has held positions in the joint departments of Epidemiology and Biostatistics, and Occupational Health in the Faculty of Medicine at McGill University, and the Montreal Regional Public Health Department.

MARK NAWACKI, C.A., M.B.A.
VICE PRESIDENT OF BUSINESS DEVELOPMENT
Prior to joining Paladin, Mr. Nawacki held several leadership positions with Pharmacia Corporation, including all Canadian business development activities, and in sales and marketing roles. Before Pharmacia, Mr. Nawacki worked for the Pillsbury Company in brand financial management, and prior to this, worked with Arthur Andersen's Canadian practice, providing financial advisory services.

JONATHAN ROSS GOODMAN | MARK BEAUDET | SAMIRA SAKHIA | TOM KOUTSAVLIS | MARK NAWACKI

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STOCK EXCHANGE LISTING
Toronto Stock Exchange
Trading symbol: PLB

SHARES OUTSTANDING
14,799,588 Common Shares
(at December 31, 2003)

FISCAL 2003 TRADING SUMMARY

High:	$6.55
Low:	$3.45
Close:	$5.00

Average daily volume: 18,594 shares

TRANSFER AGENT
Computershare Trust
Company of Canada
1-800-564-6253

AUDITORS
Ernst & Young LLP

ANNUAL GENERAL MEETING
April 29, 2004, 5 p.m.
6111 Royalmount Avenue
Suite 102
Montreal QC H4P 2T4

This Annual Report is also available
on the Internet at www.paladinlabs.com.

Ce document est aussi disponible
en français.

www.paladinlabs.com

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